

Internal Revenue Service  
**memorandum**

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Br5:CCooper

date: NOV 5 1990  
to: Matthew Wallach

from: Robert Katcher *Robert Katcher*

subject: [REDACTED]

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Your concerns regarding the dividend transaction between [REDACTED] and its [REDACTED] subsidiary were referred to us by Kim Palmerino.

We understand the facts to be as follows. In [REDACTED], [REDACTED] paid a dividend of \$ [REDACTED] all of its earnings and profits, to its two shareholders, [REDACTED] and [REDACTED]. [REDACTED] received notes in the amount of \$ [REDACTED], and [REDACTED] received \$ [REDACTED] in cash. [REDACTED] remitted this cash to [REDACTED] as payment against a prior section 1248 stock sale. [REDACTED]'s overall losses offset the dividend, which nevertheless carried up \$ [REDACTED] in section 902 credits. In [REDACTED], [REDACTED] sold the remainder of its stock in [REDACTED] to [REDACTED] in exchange for \$ [REDACTED] additional debt of the subsidiary. In [REDACTED], [REDACTED] released all of the debt of [REDACTED] in exchange for \$ [REDACTED] cash, which it credited to payment of the dividend note. It claimed a loss attributable to the release.

These facts and conclusions reflect the determinations of Appeals. [REDACTED]'s [REDACTED] tax year is closed. Nevertheless, we understand that the factual question whether the dividend note was paid or not may still remain open. Appeals has already characterized the transaction, accepted its bona fides, and established valuation. These facts are given.

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The payment of a dividend is entirely discretionary as to timing, amount and form of payment. A dividend may be paid by note. Litton Industries Inc. v. Comm., 89 T.C. 1086 (1987). Once it is established that the note to [REDACTED] was a dividend, it is as though [REDACTED] distributes cash to [REDACTED], followed by a loan from [REDACTED] to [REDACTED]. When a dividend is paid by note, the principal amount of the note is taken into income, and the distributing corporation's earnings and profits are reduced by that amount. Sections 1.301-1 (n) (1) and 1.312-1 (a) (2) of the Regulations. If the earnings and profits of the distributing corporation are reduced, section 902 credits may be claimed. See Rev. Rul. 71-65 1971-1 C.B. 212.

You had suggested that an adjustment to the Section 902 credit might be possible under the Arrowsmith doctrine (344 U.S. 6 (1952)) or the tax benefit rationale of Skelly Oil (394 U.S. 678 (1969)). We do not believe that the rationale of either Arrowsmith or Skelly Oil results in a reduced credit with respect to the [REDACTED] dividend note.

In Skelly Oil the taxpayer was required to rebate to customers amounts previously included in income. The amounts paid back, however, had been only partially subjected to tax as a result of percentage depletion deductions. The court determined that only that portion of the refunded amounts that had been previously taxed should be allowed as a deduction in the year of repayment. In this case no question is raised regarding the proper amount of dividend income originally included by [REDACTED]. Any loss later recognized attributable to the dividend note does not reduce the amount of the [REDACTED] dividend.

In Arrowsmith the taxpayer received liquidating distributions from a corporation and a judgment was rendered in a subsequent year against the corporation. The taxpayer was subject to transferee liability on the judgment as a result of the earlier liquidation with respect to which gain was realized. In effect the transferee liability to a limited extent kept the transaction open, at least with respect to the character of any subsequent loss for tax purposes. As a result the court held that the subsequent liability should be characterized by reference to the character (capital) of the earlier gain. However, the loss did not affect the amount or character of the gain reported on the original transaction. In this case, the dividend is a closed transaction. The amount of the dividend was not subject to any contingent claim at the time the dividend was made. As we state earlier, it is analogous to the distribution of cash followed by a loan back. If the cash were subsequently lost (or were used to purchase an asset

that was subsequently destroyed), the taxpayer would be entitled to a deduction in the year of the loss. However, the loss would not impact the amount of the distribution.

The question whether the dividend note was paid or not suggests that further development of the facts may reveal that the loss occurred in a previous (closed?) year. Even if the previous year is a closed year, the loss may affect open years. See Hill v. Commissioner, 95 T.C. No. 31 (10/13/90). In any event, to the extent the loss is attributable to the dividend note, it appears to us that the loss should be allocated and apportioned under section 1.861-8 of the regulations to the same class of gross income and statutory groupings as the original income inclusion.

If you have any further questions, please call  
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